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JAPAN · ECONOMIC · INSTITUTE

JEI

REPORT

NO. 11A March 21, 1986

AT A CROSSROADS: FOREIGN BANKS IN JAPAN

Summary

Japan's banking market is both a dream and a nightmare. With personal saving rates double those of the United States, and corporations that are often flush with cash, the potential for attracting deposits is tremendous. On the other hand, competition is painfully intense and the expression "bigger is better" carries great weight among bankers. Furthermore, government regulation of the financial system was very strict until recently, limiting the flexiblity of financial institutions under changing market conditions. Finally, lucrative markets that are the bread and butter of banks in Western industrialized nations are very weak in Japan.

Foreign banks have found it difficult to take root and prosper in this severe environment, but the same could be said of their Japanese counterparts. Although Tokyo's financial liberalization program brings the promise of rain after the long drought, foreign banks in Japan find themselves at a crossroads. This report will look at problems they have encountered and explore future opportunities.

The Banking Market

Japanese banks played a well-documented role in the economy's rapid postwar recovery, providing the financial lubrication and fuel to keep industry humming. But as the economy moves into the post-industrial stage, its financial needs are changing. While banks will retain a central role in

economic activity, the industry is on the brink of a major restructuring effort.

Japan's banking system, like its legal code and political machinery, was modeled after existing Western ones but adapted to Japanese needs. The National Bank Act of 1872 borrowed heavily from U.S. legislation to create a national banking system. Americans had an even greater impact on Japan's financial system during the occupation immediately following World War II when revisions in the Banking Law of 1927 set the mold for Japanese banks through the start of this decade. The most significant modification was the adoption of provisions similar to the National Banking Act of 1933 (Glass-Steagall Act) that erected barriers between commercial banking and securities dealing.

Prior to this change, banks almost completely dominated Japanese financial life and securities companies were banished to the fringe of financial markets. On the strength of their position at the center of the large, prewar industrial groups (zaibatsu), banks not only accepted deposits and issued loans, but also underwrote bond and equity issues. This dominance ended during the American occupation when banks were restricted to accepting deposits and making loans. Purchases and sales of securities were prohibited except in the following situations: on behalf of and at the express order of customers with accounts; for a bank's own investment purposes; or as required to implement a trust agreement.

Ministry of Finance administrative regulations and subsequent legislation completed the web of controls that so firmly bound Japanese banks to monetary policy and insulated them from international forces. In addition to the normal controls on reserves, deposits and lending operations, the government regulated interest rates and loan maturities as well as foreign exchange and interbank transactions. Even the number of branches and hours of operation were tightly regulated. Absent market forces, broad consumer credit markets did not develop beyond a rudimentary stage as governemnt policy encouraged corporate borrowing and individual saving. In short, Japanese banks focused their efforts on a just a few areas of activity and tended to specialize in serving some particular type of customer. The effects of specialization did not restrain their expansion, however, which is in part a reflection of the remarkable growth of the economy.

There are several different types of banks in Japan, although the distinctions have faded with time and changing regulations. Commercial banks (and just recently trust banks) count among their ranks the foreign members of Japan's banking community. Foreign banks actually opened their doors in Japan ahead of domestic institutions, but this has not translated into a strong foreign presence in the market, mainly due to the formidable competition.

In the commercial bank category, there are 12 so-called city banks, which are based primarily in urban centers but have a nationwide network of offices, and 65 regional banks, which operate primarily in rural areas. The city banks (plus the Bank of Tokyo, which was once solely a foreign-exchange bank) all rank among the world's leading commercial banks in terms of assets and profits. These institutions dominate the market for large corporate customers, while the regional banks serve the needs of small businessmen and

The JEI REPORT (ISSN 0744-6489) is published weekly for $40 per year by the Japan Economic Institute of America, 1000 Connecticut Avenue, N.W., Washington, D.C. 20036. Second class postage paid at Washington, D.C. POSTMASTERS: Send address changes to JEI, 1000 Connecticut Avenue, N.W., Washington, D.C. 20036.

consumers. Trust banks, mutual savings and loan (sogo) banks and government-operated savings institutions, such as the Postal Savings System, account for the remainder of deposits.

Out of Step with Current Conditions

Until the last 10 years, banks in Japan enjoyed a relatively simple business environment. Domestic corporations relied very heavily on bank borrowing to finance investment, government borrowing needs were modest, and the Ministry of Finance buffered the impact of international financial shocks. Thanks to rapid economic growth, loans and deposits increased with a minimum of effort. The two oil shocks of the 1970s, however, fundamentally altered this tranquil picture. Economic growth rates fell precipitously, forcing companies to scale back their borrowing plans and pushing the government into deficit spending.

This proved a devastating combination to Japanese bankers as low-paying government bonds replaced profitable corporate loans. In addition, the lean times intensified competition between banks and eroded the strength of loan portfolios as the bankruptcy rate soared. Financial institutions began to search for ways around the barriers between banking and securities operations, leading to a blurring of regulatory distinctions. By 1975 the government realized that the banking system would be unable to handle the burden of financing current deficits and refinancing past debt while at the same time helping industry cope with international competition.

These deficiencies were examined for four years by a government-appointed advisory panel that in 1979 advocated major structural modifications to the banking system. Based on these recommendations along with another report on bond and equity markets, the Ministry of Finance drew up new banking regulations that were approved by the Diet on May 25, 1981. The Banking Law of 1981 codified many MOF's administrative practices developed over the years and conferred new regulatory powers on the already powerful bureaucracy. At the same time, however, it opened the door for radical changes in the financial system by allowing Japanese commercial banks to handle the primary and secondary sales of government bonds and widening the scope of banking-related activities. In addition, it clarified the obligations and rights of foreign banks; most significantly, the Ministry of Finance granted them national treatment.

Since the new law went into effect in April 1982, financial reform has gained considerable momentum (see JEI Report No. 8A, February 28, 1986), in part thanks to an agreement with the United States on several aspects of liberalization, including securities trading, trust banking and the Euroyen market (see JEI Report No. 22B, June 8, 1984). Commercial banks gained more room to maneuver and are permitted to offer new instruments, but they also face new competition from other domestic and foreign financial institutions. At the same time, consumer and corporate expectations have increased, demanding greater sophistication from all financial institutions.

The Foreign Bank Experience

The liberalization movement has probably been hardest on foreign commercial banks operating in Japan. On the one hand, they have lost whatever

unique services they could offer Japanese companies. But on the other, they now have an opportunity to parlay their links with foreign parents and their experience in consumer and corporate finance into a stronger position.

Under the heavy guidance of MOF and the Bank of Japan, foreign banks have not enjoyed significant growth in Japan. Even after a decade of 10 percent-plus annual economic growth, there were only 18 foreign banks operating in Japan in 1970. Today, their number has grown to 78, including both firms with representative offices as well as those with branches. Nevertheless, the impact of controls is still clear. These 78 foreign banks have a total of 113 offices, far below the average for Japanese city banks (200) and regional banks (85). This limited presence has severely restricted their ability to attract deposits and make loans. They account for an average of 1 to 2 percent of all bank deposits and their share of outstanding loans has fluctuated between 2 percent and 3.5 percent since 1950 (see Tables 1-4 for comparison). MOF-imposed foreign-exchange swap limits restricted the amount of assets they could receive from the parent bank, forcing foreign banks into short-term interbank markets to raise funds. Obviously this not only limited the amounts a bank could raise but also greatly increased the cost of funds.

Foreign banks have had great difficulty attracting Japanese customers and have contented themselves with making yen loans to subsidiaries of foreign companies, or foreign currency loans (so-called "impact loans") to Japanese firms. Because foreign direct investment was only completely liberalized in the mid-1970s and MOF began allowing domestic banks to make impact loans in the late 1970s, foreign banks have not been overwhelmed with customers. According to MOF data, the growth of lending by foreign banks slowed from 30 to 50 percent in the 1960-75 period to 10 percent annually through 1983 and then to zero in fiscal 1984. Impact loans in particular contracted, from a high of $2.3 biliion in fiscal 1982 to $939 million in fiscal 1984. Even more discouraging, the foreign bank share of impact loans fell from 60 percent to 18.6 percent over the same period. Efforts by non-Japanese banks to move into areas of consumer finance, leasing and investment banking have been stymied by the morass of financial regulations. As can be seen in Table 5, earnings have suffered over the past several years. Although to date foreign banks have not played a significant role in Japan's banking market, financial liberalization may change this situation.

Perils and Opportunities in the New Environment

The new regulatory environment promises to realign and restructure Japan's entire financial system. Even the modest amount of deregulation already implemented has affected the earnings of financial institutions. According to a February 1986 Nihon Keizai Shimbun profit survey, securities companies and trust banks have moved up rapidly while medium- and small-sized city and regional banks have drifted downward. Several trends that will determine the fate of all banks in Japan are becoming evident:

- Mergers - The announced merger between Sumitomo Bank, Ltd., the third-largest city bank in terms of assets, and Heiwa Sogo Bank, Ltd., the sixth-ranked mutual savings and loan bank, ended a crisis surrounding the troubled sogo bank and is the beginning of a shakeout in the banking industry. Although this is not the largest merger between banks (Dai-Ichi Bank, Ltd. and

Nippon Kangyo Bank, Ltd. combined in 1971 to create Dai-Ichi Kangyo Bank, Ltd., still the nation's largest), it is significant in several respects. The move is considered an aggressive one given the financial distress of Heiwa Sogo. Sumitomo is convinced that Heiwa's large number of Tokyo offices, impressive pool of individual depositors and extended banking hours will prove well worth their cost. Second, MOF apparently decided to make an example of Heiwa Sogo to warn other banks that deregulation implies the freedom to fail as well as succeed. Authorities refused to step in at an early stage when it was clear that Heiwa was experiencing business problems and management strife. Nor was the usual tactic of arranging a rescue by several banks attempted. Finally, Citibank was interested in a takeover but backed away because of the sogo bank's complicated financial problems, not MOF disapproval.

The world's largest bank is not discouraged, however, and is still said to be shopping for a Japanese bank. This market is becoming crowded with buyers and sellers alike. Sumitomo's competitors are looking over the prospects and many regional banks are holding discussions aimed at banding together to compete with larger rivals. Toyo Keizai Weekly feels that if the economy slows drastically, as many as 9 city banks, 34 regional banks and 54 sogo banks will encounter problems and become possible merger targets. The opportunities for foreign banks are obvious.

- Trust banking - With an estimated Y50 trillion ($277.8 billion at Y180=$1.00) in government pension trusts and as much as three times that in private trusts, the lure of trust banking is overpowering. In the past six months, six American banks have received MOF permission to operate trust banks in Japan: Morgan Guaranty Trust Co., Bankers Trust Co., Chemical Bank, Chase Manhattan Bank, Citibank and most recently Manufacturers Hanover Trust Co. Although some issues remain, it is expected that more banks from the United States and Europe will follow as Japan's society ages and pension funds balloon.

- Commercial paper - This is a major innovation under the 1981 Banking Law. Although banks have been lobbying MOF against the creation of such a market since it would reduce corporate reliance on bank lending even further, its inception is clearly on the horizon. Given their expertise at handling the fast-moving U.S. market for corporate credit, American banks may stake out a strong position in any future Japanese market.

- Bond futures - After a rocky start in October 1985, the bond futures market has settled down and is showing good potential. Since interest rates have fallen and investors are becoming better acquainted with the market, trading should expand quickly. This is another market that is old hat to U.S. banks and may therefore offer another avenue of expansion.

- Consumer finance - This market will undoubtedly take many years to develop into a profitable business. Nevertheless, the field has been receiving fresh attention from domestic and foreign banks alike. Citibank is interested in buying a small Japanese bank primarily to offer expanded consumer financing services. Other Japanese banks see a trend toward more leisure and luxury and are eager to fulfill those desires. Regulatory barriers remain, however, and MOF has been reluctant to discuss the issue. Furthermore, institutional weaknesses severely hamper consumer financing efforts. The absence of

independent consumer credit rating organizations is a real problem. If the credit infrastructure can be brought to an acceptable level, however, the abundant pool of personal savings could mean a lucrative consumer finance market.

- Electronic services - Japan has staked its future on electronics and integrated communications. It is no surprise, therefore, that Japanese banks are interested in capitalizing on this trend. Automatic teller machines are presently installed only at branch offices and operate exclusively during regular business hours. The banks' game plan seems to be to get the hours of operation extended and then hope for permission to put the ATMs in stores and shopping areas. Ultimately, the banks hope to link their equipment with the point-of-sale systems now being installed by retailers to create a debit card system (see JEI Report No. 44B, November 15, 1985). Value-added network systems are another area that banks hope to penetrate. Offering on-line banking, investment and cash management services holds the promise of lower operating costs for banks and more efficient use of funds for corporations. For U.S. banks, which have employed such systems for several years, these improvements offer the potential to acquire an increased share of these markets.

- International services - MOF's yen internationalization program has created a booming market for international banking services. Although Japanese firms are moving aggressively abroad to meet these needs, American and European banks are well-entrenched and eager to go toe-to-toe with the Japanese. By expanding into Japan, moreover, some foreign firms may be able to further strengthen their hand. Both trends will hasten the advent of 24-hour banking.

Outlook

The Japanese banking market is clearly in ferment and MOF is only likely to turn up the heat. Just recently the ministry hinted that it was considering weakening the remaining distinctions between commercial and investment banking. As interest rates are slowly deregulated and controls on trust managers and corporate comptrollers are eliminated, banks will have to supply increasingly sophisticated services to stay competitive.

MOF hopes to prepare Japanese banks for full integration into the international financial system by establishing an offshore banking facility in Tokyo. Legislation enabling this artificial haven from domestic financial regulations will be submitted to the current Diet for implementation as early as October. Foreign banks would find this arrangement much more favorable since Japanese corporations are expected to flock to the market and it would operate as the offshore facilities in New York and London now do.

If MOF continues on its course of blurring barriers, banks will hasten to participate in 24-hour bond and securities trading as it develops. With Japan's savings rate unlikely to fall significantly and controls on international capital flows easing, Japan almost surely will assume the position of top creditor nation -- if it has not already done so. Although the economic implications are unclear, it will definitely result in fat profits for domestic and foreign banks and securities firms.

However, there are some clouds in the sky. Japan is becoming increasingly embroiled in bilateral negotiations over financial reciprocity with its major trading partners, most notably the United States and Great Britain. If these negotiations are not successfully resolved, foreign and Japanese banks may find themselves barred from each other's markets to the detriment of all concerned.

For many reasons, foreign banks are at a crossroads in Japan. After years of poor results, should they hold on, hoping that MOF's liberalization plans will offer fresh growth opportunities; or withdraw and wait for the Japanese to come to them? While some have answered with the latter, most seem to be taking the optimistic view and are persisting in their efforts to meet the financial needs of the world's second-largest economy.

For further information, contact Jon Choy.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

Table 1: Principal Accounts of Foreign Banks in Japan, 1981-85

(figures for December of each year in billions of yen)

	1981	1982	1983	1984	1985
Assets					
Cash and Deposits	Y3,236.9	Y3,520.4	Y3,718.3	Y3,353.5	Y2,024.2
Call Loans	868.4	993.5	1,029.8	1,509.2	1,663.3
Bills Bought	69.7	178.5	389.4	224.6	1,416.1
Securities	351.7	255.4	323.9	390.7	515.8
Loans	5,292.8	5,892.3	6,617.7	6,848.8	4,888.3
Total	9,819.5	10,840.1	12,079.1	12,326.8	10,507.7
Liabilities					
Deposits	Y1,389.5	Y1,500.1	Y1,591.0	Y1,898.9	Y1,711.6
Certificates of Deposit	413.7	362.9	429.3	404.9	754.0
Call Money	1,789.5	2,278.2	2,971.4	2,717.5	2,086.8
Bills Sold	873.4	530.5	889.3	504.8	263.5
Borrowed Money	740.1	826.9	976.5	1,129.3	1,352.3
Total	5,206.2	5,498.6	6,857.5	6,655.4	6,168.2

Table 2: Accounts of All Banks in Japan, 1981-85

(figures for December of each year in billions of yen)

	1981	1982	1983	1984	1985
Assets					
Cash and Deposits	Y17,087.9	Y18,267.8	Y21,271.8	Y24,029.4	Y25,884.0
Call Loans	5,758.1	8,147.4	10,404.6	9,526.4	13,076.9
Bills Bought	416.2	582.9	309.9	429.6	1,256.6
Securities	43,205.0	45,605.5	49,141.0	52,557.9	57,790.4
Loans	151,213.7	167,677.5	186,346.3	210,479.0	237,170.0
Foreign Exchange	6,307.6	5,835.4	5,514.6	5,887.4	6,436.8
Acceptances	16,824.7	17,331.9	17,096.6	17,853.2	20,426.2
Total	249,887.2	272,412.6	299,507.5	332,354.7	376,236.7
Liabilities and Net Worth					
Deposits	Y168,744.5	Y179,995.7	Y194,895.5	Y211,031.3	Y230,601.9
Certificates of Deposit	2,674.0	3,581.1	4,612.4	7,210.7	7,979.6
Bank Debentures	21,182.5	23,337.6	26,265.1	29,379.4	31,454.2
Call Money	7,464.9	9,195.6	10,805.0	12,305.3	15,704.1
Bills Sold	2,743.4	4,888.5	5,859.1	7,372.5	14,199.6
Borrowed Money	1,563.9	2,119.1	3,712.2	3,015.0	4,186.6
Foreign Exchange	1,976.5	2,156.0	1,572.1	1,246.3	1,187.8
Guarantees	16,824.7	17,331.9	17,096.6	17,853.2	20,426.2
Capital	2,050.0	2,095.7	2,165.7	2,240.2	2,426.6
Profit/Loss	3,988.7	4,067.8	5,479.6	6,086.2	6,063.1
Total	249,887.2	272,412.6	299,507.5	332,354.7	376,236.7

Table 3: Accounts of City Banks, 1981-85

(figures for December of each year in billions of yen)

	1981	1982	1983	1984	1985
Assets					
Cash and Deposits	Y10,677.3	Y11,262.7	Y13,240.4	Y14,750.8	Y15,483.3
Call Loans	3,584.3	4,851.4	6,191.5	5,002.5	7,279.1
Bills Bought	--	--	--	--	394.0
Securities	17,363.6	17,738.2	19,168.1	20,134.8	22,101.7
Loans	78,801.2	87,094.9	96,438.9	108,128.1	123,471.2
Foreign Exchange	4,939.4	4,714.7	4,550.9	4,813.1	5,114.2
Acceptances	10,881.1	11,398.6	11,188.8	11,447.8	13,179.4
Total	131,242.6	141,903.2	155,707.1	170,185.8	193,970.2
Liabilities and Net Worth					
Deposits	93,972.5	99,022.2	107,890.0	114,814.8	125,619.5
Certificates of Deposit	1,855.6	2,085.4	2,750.2	4,595.6	4,890.5
Bank Debentures	1,565.8	1,825.7	2,095.5	2,285.7	2,599.0
Call Money	5,942.2	6,771.8	7,071.8	7,997.6	6,834.5
Bills Sold	2,709.8	4,834.6	5,787.6	7,160.5	12,590.0
Borrowed Money	1,313.8	1,929.4	3,370.5	2,692.0	3,543.5
Foreign Exchange	1,366.7	1,626.6	1,155.4	958.0	1,033.0
Guarantees	10,881.1	11,398.6	11,188.8	11,447.8	13,179.4
Capital	1,027.0	1,048.0	1,062.0	1,079.7	1,209.1
Profit/Loss	1,424.6	1,337.1	1,905.6	1,970.0	1,794.5
Total	131,242.6	141,903.2	155,707.1	170,185.8	193,970.2

Table 4: Accounts of Regional Banks, 1981-85

(figures for December of each year in billions of yen)

	1981	1982	1983	1984	1985
Assets					
Cash and Deposits	Y4,082.6	Y4,380.3	Y4,855.6	Y5,574.9	Y5,729.0
Call Loans	1,405.7	2,021.5	2,583.6	2,867.2	3,930.6
Bills Bought	272.5	184.3	67.9	133.6	483.4
Securities	15,911.8	16,706.1	17,485.3	18,314.9	19,405.8
Loans	48,448.8	53,143.5	58,394.2	65,430.6	70,853.5
Foreign Exchange	322.7	321.4	345.2	403.2	457.3
Acceptances	2,735.8	2,559.5	2,425.6	2,575.7	2,656.3
Total	75,758.3	81,999.8	89,005.1	99,020.9	107,892.6
Liabilities and Net Worth					
Deposits	Y65,028.6	Y70,537.2	Y75,801.1	Y83,731.4	Y90,733.3
Certificates of Deposit	420.4	744.7	1,145.8	1,760.5	1,763.0
Bank Debentures	--	--	--	--	--
Call Money	435.0	588.8	1,030.4	987.7	2,106.1
Bills Sold	30.5	53.9	55.0	212.0	517.1
Borrowed Money	213.3	236.2	313.8	289.9	326.6
Foreign Exchange	104.9	102.6	105.4	77.1	49.1
Guarantees	2,735.8	2,559.5	2,425.6	2,575.7	2,656.3
Capital	559.0	583.6	602.0	648.2	688.5
Profit/Loss	1,828.3	1,972.3	2,664.6	2,983.0	2,908.0
Total	75,758.3	81,999.8	89,005.1	99,020.9	107,892.6

Table 5: Top Japanese and Foreign Banks in Japan, FY 1983-84

(place among all private commercial banks and net income in millions of yen)

	FY 1983		FY 1984	
	Rank	Net Income	Rank	Net Income
Sumitomo Bank, Ltd.	1	Y199,828	1	Y157,096
Fuji Bank, Ltd.	2	165,552	3	152,064
Sanwa Bank, Ltd.	3	131,267	2	152,782
Mitsubishi Bank, Ltd.	4	117,324	4	136,242
Dai-Ichi Kangyo Bank, Ltd.	5	99,338	5	133,532
Mitsui Bank, Ltd.	6	86,394	9	82,023
Tokai Bank, Ltd.	7	70,038	8	82,158
Bank of Tokyo, Ltd.	8	61,077	7	109,708
Taiyo Kobe Bank, Ltd.	9	58,931	11	60,228
Nippon Credit Bank, Ltd.	10	40,867	12	51,463
Citibank	94	2,384	86	3,652
Deutsches Bank	96	1,728	101	1,309
Morgan Guaranty Trust Co.	99	1,108	99	1,464
Manufacturers Hanover Trust Co.	101	938	--	n.a.
Chemical Bank	102	960	94	2,362
Bank Indosuez	104	853	--	n.a.
Lloyds' Bank International, Ltd.	105	712	118	295
Bangkok Bank, Ltd.	106	695	126	171
Bank of India, Ltd.	109	492	109	501
Indostate Bank, Ltd.	110	444	110	474
Wells Fargo Bank	111	436	114	319
American Express International	112	414	119	293
Bank of America	--	n.a.	98	1,516
Bankers Trust Co.	--	n.a.	104	839
Irving Trust Co.	--	n.a.	107	700

Source: Toyo Keizai Shukan, May 19, 1984 and September 7, 1985.